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Supreme Court of the United States

October Term, 1996

UNITED STATES OF AMERICA,

Petitioner,

vs.

JAMES HERMAN O'HAGAN,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Eighth Circuit

BRIEF OF *AMICUS CURIAE* ASSOCIATION FOR INVESTMENT MANAGEMENT AND RESEARCH IN SUPPORT OF PETITIONER

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INTEREST OF *AMICUS CURIAE*

The Association for Investment Management and Research ("AIMR")[1] is a global, non-profit membership organization with more than 70,000 members and candidates worldwide. AIMR was formed in 1990 through the merger of the Financial Analysts Federation ("FAF") and the Institute of Chartered Financial Analysts ("ICFA"), organizations which have represented investment professionals since 1947. AIMR's members and candidates are securities analysts, portfolio managers and other investment decision-makers employed by investment management counseling firms, banks, broker-dealers, mutual fund complexes, pension fund consultants, and insurance companies. Directly and through their employers, AIMR members and candidates manage more than six trillion dollars in assets worldwide. AIMR also sponsors the Chartered Financial Analyst ("CFA") designation program. The CFA charter is an internationally recognized credential certifying the highest achievement in the investment profession.

AIMR members must comply with the Association's *Code of Ethics* and *Standards of Professional Conduct*. *See* ASSOCIATION FOR INVESTMENT MANAGEMENT AND RESEARCH, STANDARDS OF PRACTICE HANDBOOK (7th ed. 1996) ("HANDBOOK"). Since first promulgated in 1962, the *Standards of Professional Conduct* applicable to AIMR's members have prohibited the use of material, nonpublic information, including misappropriated information. Presently, the relevant standard states:

> Members who possess material non-public information related to the value of a security

---

1. Counsel for a party did not author this brief in whole or in part and no person or entity, other than the *amicus curiae*, its members, or counsel, have made a monetary contribution to the preparation or submission of the brief. Pursuant to Rule 37 of the Rules of the Court, the parties have consented to the filing of this brief. Their letters of consent have been filed with the Clerk of the Court.

> shall not trade or cause others to trade in that security if such trading would breach a duty or if the information was misappropriated or relates to a tender offer. If members receive material non-public information in confidence, they shall not breach that confidence by trading or causing others to trade in securities to which such information relates. Members shall make reasonable efforts to achieve public dissemination of material non-public information disclosed in breach of a duty.

HANDBOOK, Standard V(A), p. 141. Through its Professional Conduct Program, AIMR promotes and maintains the highest professional standards for its members and the investment industry.

As investment professionals, AIMR's members have a substantial interest in the development of the regulation of insider trading matters, which impact their daily activities in the securities markets. AIMR and its predecessor organizations have long supported efforts to prohibit insider trading and the misuse of material, nonpublic information, believing these efforts are necessary to maintain investors' confidence in the integrity of the markets. AIMR believes that the misappropriation theory is an essential tool in the regulation of improper insider trading activity. Any AIMR member who misappropriates material, nonpublic information and uses it as the basis for a securities recommendation or transaction violates the AIMR Standards of Conduct, regardless of whether the member owes a duty to the shareholders of the company, the member's employer, or any other person or entity. HANDBOOK, p. 174.[2]

In supporting efforts to prohibit insider trading, AIMR has

2. The Standard applies to members of AIMR who directly misappropriate material nonpublic information. *See* HANDBOOK, p. 174.

consistently emphasized the importance of protecting the legitimate exchange of information between corporations and securities analysts. The free flow of such information is crucial to the efficient functioning of the U.S. capital markets. As the primary professional association representing analysts and other investment practitioners, AIMR is an interested party in the case and AIMR requests the Court ratify the misappropriation theory of insider trading liability. In so doing the Court should clearly define the parameters of the theory to ensure the continued protection of the valuable role of investment professionals in the securities markets under the principles set forth in *Dirks v. SEC*, 463 U.S. 646, 103 S. Ct. 3255 (1983).

SUMMARY OF ARGUMENT

AIMR supports approval of the "misappropriation theory" of insider trading liability, and urges the Court to define the requirements and reach of the theory as clearly as possible. To reach the type of undesirable conduct which Section 10(b) of the Securities Exchange Act of 1934 (the "Act"), 15 U.S.C. § 78j(b), sought to prohibit, while ensuring the free flow of information needed by market analysts, the misappropriation theory must be clearly defined. While bright-line rules are understandably difficult to craft when dealing with the myriad of settings in which nonpublic information may be obtained, AIMR believes that such a test is critical to allow analysts to function efficiently in the market, benefiting all investors. The absence of a bright-line test has a chilling effect on the free flow of information which hinders the analyst's ability to make informed decisions concerning the value of the securities of a corporation. This, in turn, reduces the amount of information available to the market, harming investors. AIMR advocates a bright-line test holding that the disclosure of material, nonpublic information to or by an analyst violates Section 10(b) only if the disclosure is for **personal gain,** such as pecuniary gain or reputational benefit that would translate to future earnings or use of the information as gifts to friends or relatives. AIMR

believes this approach would create greater certainty; facilitating the free flow of information while allowing the SEC to reach undesirable conduct in the market.

The adoption of such a "misappropriation theory" is consistent with the plain language of Section 10(b) of the Act as well as Congressional intent reflected in more recent amendments to the securities laws, which can be fairly said to have ratified the misappropriation theory developed in the lower federal courts. This is an appropriate case — concerning an egregious misuse of confidential information by an attorney — for this Court to confirm that misappropriation of material, nonpublic information is unlawful.

ARGUMENT

Under the classical theory of insider trading liability as developed by this Court, a person is liable for trading on material, nonpublic information under Section 10(b) of the Act if:

(i) he owes a fiduciary or similar duty to the other party to the transaction;

(ii) he is an insider of the company in whose shares he trades and thus owes a fiduciary duty to the company's shareholders; or

(iii) he is a tippee who received his information from an insider of the company and knows, or should know, that the insider breached a fiduciary duty in disclosing the information to him.

The classical theory of liability, which requires that a duty be owed to the company whose shares are traded, does not regulate important instances of manipulative or deceptive

practices in connection with the purchase and sale of securities.[3] The misappropriation theory was developed to cover those gaps in the classical theory where trading in material, nonpublic information violated a fiduciary or similar duty, irrespective of whether the duty was owed to the company whose securities were traded.

Without an effective theory of liability to combat such fraud, the integrity of the market for securities necessarily suffers and investors are harmed. Thus, AIMR believes that a clearly stated misappropriation theory is a proper exercise of judicial authority which is vital to the effective regulation of improper insider trading. In this brief *amicus curiae*, AIMR first discusses the importance of the analyst's role, the benefits of a free flow of information and the need for clarity in this area. In the second part, AIMR submits that the misappropriation theory is valid under Section 10(b) of the Act.

3. For example, the classical theory does not extend to:

(i) trading on material nonpublic information by outsiders (i.e., persons who are neither insiders of the company whose shares are being traded nor tippees of such insiders);

(ii) transactions in the securities of proposed acquired companies by insiders of the acquiring company, including officers, directors, investment bankers and the like;

(iii) transactions in securities of suppliers and other companies about which corporate or government officials have material information;

(iv) transactions in securities by brokerage and investment advisory firm employees in companies which are the subject of unpublished research reports;

(v) transactions in securities by employees on the basis of information stolen from employers as long as such information does not relate to the employer's own securities; or

(vi) transactions on the basis of inside information by officers, directors and other insiders in debt securities issued by their own companies.

I. A CLEARLY DEFINED MISAPPROPRIATION THEORY WILL GIVE GUIDANCE AND PROTECTION TO INVESTMENT ANALYSTS AND MARKET PARTICIPANTS GENERALLY.

A. Analysts Play A Vital Role In The Efficient Functioning Of The Market.

Securities analysts and investment managers function in a variety of contexts in the securities industry through their work for broker-dealers, banks, investment advisers, mutual fund complexes, insurance companies, pension funds and other employers. A financial analyst must gather and interpret large quantities of information from many sources; success requires diligent information gathering, analytical skill and a sensitive intuition. The analyst is often active in "ferreting out" relevant information. Analysts typically search for, assemble and evaluate information about companies and their securities, and issue reports and investment recommendations to individual and institutional investors. Investment managers utilize the research of analysts, as well as their own investment experience and analyses, in making investment decisions on behalf of their clients and employers.

An analyst must make judgments regarding the economy as a whole, as well as the prospects of a particular industry. Beyond an understanding of macroeconomic factors, an analyst must examine the individual characteristics of the companies being followed. For example:

> Foreign exposure, competitiveness of product lines, pricing flexibility, efficiency, cost controls, tax rates, financial position, accounting practices and the historical financial record are only a few of the variables that differentiate companies. The analyst combines his understanding of these

> many dynamic variables to estimate, among other key factors, future earnings and dividends. . . . Even after estimating future earnings and dividends, [the analyst] must assess the price at which a security may sell. The price/earnings ratio contributes importantly to the variability of a particular security's price, and as a part of his work the financial analyst must make this essential value judgment.

FAF Guidelines on Inside Information, *Financial Analysts Journal*, January – February 1974.

This Court recognized the value of the analyst's position in the marketplace in *Dirks v. SEC*, 463 U.S. 646, 103 S. Ct. 3255 (1983). In *Dirks*, this Court considered whether an analyst, who had received material, nonpublic information from insiders concerning fraud and had broadly disseminated that information, had violated Section 10(b). *Id.* This Court in *Dirks* found he had not, reaffirming the holding set forth in *Chiarella v. United States*, 445 U.S. 222, 100 S. Ct. 1108 (1980), that insider trading liability should not result "merely from one's ability to acquire information because of his position in the market." *See Dirks*, 463 U.S. at 658 (citing *Chiarella*, 445 U.S. at 232-33 n. 14). This Court specifically found:

> Imposing a duty to disclose or abstain solely because a person knowingly receives material nonpublic information from an insider and trades on it could have an inhibiting influence on the role of market analysts, which the SEC itself recognizes is necessary to the preservation of a healthy market. It is commonplace for analysts to "ferret out and analyze information" . . . and this often is

> done by meeting with and questioning corporate officers and others who are insiders. And information that analysts obtain normally may be the basis for judgments as to the market worth of a corporation's securities. The analyst's judgment in this respect is made available in market letters or otherwise to clients of the firm. It is the nature of this type of information, and indeed of the markets themselves, that such information cannot be made simultaneously available to all of the corporation's stockholders or to the public generally.

Id. at 658-59 (citations omitted). *See also State Teachers Retirement Board v. Fluor Corp.*, 592 F. Supp. 592, 594 (S.D.N.Y. 1984) ("[b]ecause the incentive to gather market information derives from the ability of traders to use that information profitably, the Court in *Dirks* was loathe to find that the mere possession and use of nonpublic, material information amounted to a 10b-5 violation. Such restrictions could have restrained the endeavors of market analysts, whose inquiries are 'necessary to the preservation of a healthy market' ") (quoting *Dirks*, 463 U.S. at 658).

The analyst's crucial role in the market also has been recognized by the SEC. The SEC has stated that the analyst's role is invaluable to investors generally:

> The value to the entire market of these efforts cannot be gainsaid; market efficiency in pricing is significantly enhanced by such initiatives to ferret out and analyze information, and thus the analyst's work redounds to the benefit of all investors.

In re Dirks, 47 S.E.C. 434, 441 (1981) (citations omitted) (cited in *Dirks*, 463 U.S. at 659 n. 17). The continuing vitality of these principles in the securities markets in 1997 is beyond question. The role of the analyst in the market continues to be a critical one worthy of acknowledgment and protection from this Court.

Essential to the practice of financial analysts is the free flow of information. *See Dirks*, 463 U.S. at 658. *See also* Note, *Securities Regulation – Dirks v. SEC: Tippee Liability After Chiarella v. United States*, 59 TUL. L. REV. 502, 515 n. 44 (1984) ("The Court [in *Dirks*] indicated that market analysts deserved particular freedom due to their role in analyzing and disseminating corporate information disclosed in compliance with the securities acts."). For the fair and efficient operation of the capital markets, analysts and investors must have the maximum amount of information possible to facilitate well-informed decisions about how and where to invest capital. These disclosures must go beyond the information mandated by the reporting requirements of the federal securities laws and should extend to specific business information about matters relevant to a company's future growth, such as new products, capital projects and the competitive environment. Analysts seek and use such information to compare and contrast investment alternatives.

Nor is the analyst's role a passive one. A successful analyst works to uncover information concerning a company, increasing the amount of information available to the market as a whole. Indeed, the private efforts of analysts in digging up information relevant to the market is an important supplement to the public disclosures required by the securities laws. *Cf.*, *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 382, 90 S. Ct. 616, 620 (1970) (pointing out that private enforcement of the proxy rules under the Act provided a necessary supplement to SEC action).

Analysts often receive such information through contacts

with corporate insiders, especially investor relations and finance officers. Information may be disseminated in the form of press releases, through oral presentations by company executives in analysts' meetings or conference calls, or during analysts' visits to company premises. *See* ASSOCIATION FOR INVESTMENT MANAGEMENT AND RESEARCH, FINANCIAL REPORTING IN THE 1990s AND BEYOND (1993). Analysts also reach beyond contacts with companies themselves to sources such as customers, contractors, suppliers and competitors in seeking to develop the most accurate and complete picture of a company.

Another important tool for the analyst is the use of the "mosaic theory" in analyzing a company. The "mosaic theory" has come to describe the process by which an analyst may use a significant conclusion derived from perceptive analysis of public information and nonmaterial, nonpublic information as the basis of a securities recommendation or transaction. This process of reaching a recommendation should not give rise to insider trading liability, even if the conclusion derived would have constituted restricted material, nonpublic information had it been communicated directly to the analyst by an insider. An example would be an analyst concluding that a merger was likely between two public companies based on a variety of information which forms a pattern or "mosaic." This conclusion would not be subject to insider trading liability, under the "classical" or "misappropriation" theory, even if the news of a likely merger, if received directly, would be unlawful.

All of these crucial activities, which form the basis of the analysts' opinions and recommendations, require the free flow of information without the fear of action by the SEC. Indeed, AIMR cannot overemphasize the importance of such exchanges of information to its membership and the efficient functioning of the market.

B. Uncertainty Concerning The Scope Of The Misappropriation Theory Chills The Free Flow Of Information.

Because of the relative dearth of judicial opinions pertaining to analysts in the insider trading context, the exercise of analytical function and the free flow of information are sometimes chilled by uncertainties in the law. *See* John C. Coffee, Jr., "Disclosures to Analysts are Risky," *National Law Journal* (Feb. 1, 1993) at A20 (among the negative consequences of chilling the discourse between analysts and corporations is the increased likelihood that the market will be more frequently "surprised" by announcements which depart from analysts' forecasts). As this Court stated in *Dirks*, "[w]ithout legal limitations, market participants are forced to rely on the reasonableness of the SEC's litigation strategy, but that can be hazardous, as the facts of this case make plain." *Dirks*, 463 U.S. at 664 n. 24. *See also Central Bank of Denver N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, __, 114 S. Ct. 1439, 1454 (1994) (the securities market "demands certainty and predictability"); *United States v. Bryan*, 58 F.3d 933, 950 (4th Cir. 1995) ("[a]bsent clearly defined rules, investors find themselves the target of *ad hoc* decisionmaking or pawns in an overall litigation strategy known only to the SEC."); *United States v. Chestman*, 947 F.2d 551, 567 (2nd Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992) (recognizing that without clear guidelines, "efforts to construe Rule 10b-5 [could] lose method and predictability, taking over 'the whole corporate universe'. . .") (citations omitted).

Uncertainty regarding the breadth of the misappropriation theory inhibits the exchange of information between investment professionals and the companies they analyze, as well as other valuable sources who have a relationship to the company. For example, analysts often seek information from a company's customers and suppliers in evaluating its business prospects and

financial status. The flow of information should not be chilled by uncertainty as to the nature of the relationship that the analyst's source has with the company. Absent the sort of "tipping for personal benefit" referred to by the Court in *Dirks*, an analyst should be permitted to use the information derived from such contacts without fear of liability for insider trading. Without a bright-line test, market participants are forced to define the SEC's enforcement strategy before they can be confident that the exchange of information is permissible.

C. This Court Should Clarify The Misappropriation Theory Based On The "Personal Gain" Principle Set Forth In *Dirks*.

As set forth above, AIMR has long recognized that insider trading regulation is necessary to ensure the perception of integrity which is critical to investor confidence in the capital markets. The "classical theory" of insider trading reaches persons who trade on the stocks of the company of which they are insiders, while in possession of material, nonpublic information. In contrast, the misappropriation theory reaches persons who trade on material, nonpublic information for their own personal gain, even if they are not insiders of the company in whose stock they traded. *See SEC v. Maio*, 51 F.3d 623, 631 (7th Cir. 1995). AIMR believes that the misappropriation theory is a valid exercise of judicial authority which constitutes a crucial aspect of the insider trading prohibition and should be endorsed by this Court. *See* Barbara Bader Aldave, *The Misappropriation Theory: Carpenter and Its Aftermath*, 49 Ohio St. L.J. 373, 379 (1988) (noting that the victims of trading on the basis of misappropriated information are other members of the investing public who were induced by the fraudulent misappropriator's trading to buy or sell on unfavorable terms or were preempted by the misappropriator's trading from buying or selling on favorable terms). The misappropriation theory effectuates the legislative purposes of the anti-fraud provisions "to assure that dealing in securities is fair and without undue preferences or

advantages among investors," H.R. Conf. Rep. No. 94-229, p. 91 (1975), and to prohibit "those manipulative and deceptive practices which have been demonstrated to fulfill no useful function." S. Rep. No. 792, 73rd Cong., 2d Sess. 6 (1934).

In the absence of the misappropriation theory, an imbalance in access to information inevitably will result, discouraging less informed investors from entering the market. In addition, the research and analysis function performed by investment professionals will be devalued as investors perceive the market to be "rigged" in favor of those who possess material, nonpublic information. The theory is consistent with the plain language and intent of Congress, as set forth below, and as found by most of the lower courts which have considered the question.

While AIMR urges the ratification of the misappropriation theory, we respectfully request that this Court clarify the parameters of the theory, in order to facilitate its future application. Although a bright-line test is understandably difficult to craft when dealing with the myriad of settings in which nonpublic information may be obtained and used, Rule 14e-3(a) is an example of an effective clearly-drawn regulation in the securities context.[4] AIMR believes that the inquiry as to whether certain acts have violated Section 10(b) through misappropriation of information should center on whether the material, nonpublic information is used for the "personal gain" of either the outside source of the information or the analyst.

---

4. *See Chestman*, 947 F.2d at 557 (describing Rule 14e-3(a) "[Rule 14e-3(a) is a disclosure provision. It creates a duty in those traders who fall within its ambit to abstain or disclose, without regard to whether the trader owes a pre-existing fiduciary duty to respect the confidentiality of the information."). AIMR agrees with the analysis of the Second Circuit in *Chestman* that Rule 14e-3(a) is validly adopted by the SEC, independent of whether the "misappropriation theory" is upheld under Section 10(b). AIMR would also support an SEC Rule to clarify the scope of the misappropriation doctrine under Section 10(b).

In crafting this test, AIMR respectfully asks that the Court take special note of the unique role of the analyst in the market.

This Court should reiterate that the protections afforded to analysts in *Dirks* are as fully applicable to a "misappropriation theory" of insider trading liability as they are to "classical" insider trading. Thus, an analyst who is receiving material, nonpublic information from a noninsider source but neither knows nor reasonably should know that the source has misappropriated the information for "personal gain," should be free to utilize that information. In addition, the Court should clarify that a noninsider source, such as a customer, competitor or supplier, would not be subject to liability under the misappropriation theory for providing material, nonpublic information to an analyst if such communication is not made for personal gain. Of course, consistent with AIMR standards, the active misappropriation of material, nonpublic information by an analyst, such as the unauthorized reading or copying of company documents, would be illegal under the misappropriation theory as advocated by AIMR.

This Court addressed the meaning of personal gain in *Dirks*, where personal gain was defined as the receipt of "a direct or indirect personal benefit from the disclosure, such as pecuniary gain or reputational benefit that will translate into future earning." *Dirks*, 463 U.S. at 663. Additionally, this Court noted that a gift of confidential information to a relative or friend who then trades on it may be considered a personal benefit. *Id.* at 664. AIMR also has defined "personal benefit" in a similar fashion; the AIMR Standard states:

> The personal benefit to the insider is often financial, but a breach of duty may also be found in the following circumstances:
>
> - the tipper's reputation in the financial community is enhanced by the disclosure;

> - a relationship exists between the insider and the tippee that suggests a quid pro quo from the insider to the tippee;
>
> - the insider makes a "gift" of confidential information to a friend or relative.

HANDBOOK, p. 171.

The extension of *Dirks*' protection of analysts is also consistent with the SEC's suggestion, in 1987, of a safe harbor for analysts in connection with the proposed codification of the misappropriation theory. The SEC proposed a special exemptive provision for communications by analysts in the regular course of business or to analysts whose communications were not made for "personal benefit."[5]

---

5. The proposed language of the exemptive provision excluded:

> any communication made:
>
> (A) in the ordinary course of business by a person engaged in the business of analyzing and disseminating information concerning securities, the market for securities, or the financial condition of issuers; or
>
> (B) to a person engaged in . . . [that same business], if such communication is not made for the personal benefit of the person making the communication.

Donald C. Langevoort, *Investment Analysts and The Law of Insider Trading*, 76 VA. L. REV. 1023, 1035-1036 (1990). The SEC eventually agreed to a so-called reconciliation draft of legislation which dropped the explicit safe-harbor for the analyst. However, the SEC's support of the reconciliation draft was dependent on the inclusion in the legislative history of language designed to assure that the legislation would not threaten the legitimate activities of investment analysts. *Id.* at 1036. As discussed more fully below, *see* pp. 20-24 *infra*, Congress did not codify the misappropriation theory but clearly indicated its support for the theory and ratified the misappropriation theory in the Insider Trading and Enforcement Act of 1988.

Focusing the inquiry on whether a person has violated Section 10(b) and Rule 10b-5 on whether dissemination of material nonpublic information was for personal gain, is consistent with this Court's analysis in *Dirks*. In describing the standard for determining whether a party had engaged in insider trading, the Court stated:

> [I]n determining whether the insider's purpose in making a particular disclosure is fraudulent, the SEC and the courts are not required to read the parties' minds . . . [rather] [t]his requires courts to focus on objective criteria, i.e., whether the insider receives a direct or indirect personal benefit from the disclosure, such as pecuniary gain or reputational benefit that will translate into future earnings.

Dirks, 463 U.S. at 663. *See also Chiarella*, 445 U.S. 222, 242 (in crafting the misappropriation theory Justice Burger emphasized "[l]ikewise, market specialists would not be subject to a disclose-or-refrain requirement in the performance of their every day market functions. . . . [;] trading is accomplished on the basis of material, nonpublic information, but the information has not been unlawfully converted **for personal gain**") (emphasis added); *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 n. 15 (1961) (one purpose of the securities laws was to eliminate the use of inside information **for personal advantage**).

A focus on personal gain also is consistent with Congress's interpretation of Section 10(b) in considering the enactment of the Insider Trading Sanctions Act of 1984 (the "1984 Act"). The House Report accompanying the legislation clearly established that Congress considered the misappropriation theory a valid interpretation of Section 10(b) and stated:

> in certain widely publicized instances, agents of tender offerors and persons contemplating a merger or acquisition have used for personal gain information entrusted to them solely for a business purpose. Such conversion **for personal gain** of information lawfully obtained abuses relationships of trust and confidence and is no less reprehensible than the outright theft of nonpublic information.

H.R. Rep. No. 355, 98th Cong., 2nd Sess. at 4-5 (1983) (emphasis added).

As noted in *Dirks* the emphasis on whether the information was used for personal gain, rather than only the amorphous concept of the existence of a fiduciary duty or similar relationship of trust, provides the courts with an "objective criteria" for determining whether the disclosure of material, nonpublic information was a violation of Section 10(b). The existence of an objective criteria for making this determination, as well as a relatively bright-line test concerning the responsibilities of analysts and their sources, will encourage the free flow of information to analysts so necessary for the efficient functioning of the market while providing the SEC with sufficient authority to reach "those manipulative and deceptive practices which have been demonstrated to fulfill no useful function'," *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 474 n. 13, 97 S. Ct. 1282, 1391 n. 13 (1977).[6]

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6. Even courts which refused to apply the misappropriation theory have vehemently condemned the behavior of the misappropriator. *See Bryan*, 58 F.3d at 959 ("[o]ur rejection of the misappropriation theory certainly should not be taken as approval of the kind of conduct of which Bryan was convicted, not should it be perceived as evidencing a view that such conduct is not properly the subject of criminal liability."); *United States v. O'Hagan*, 92 F.2d 612, 628 (8th Cir.), *cert. granted*, 136 L. Ed. 2d 695, 65 U.S.L.W. 3505 (Cont'd)

II. THIS COURT'S ADOPTION AND ARTICULATION OF A CLEARLY DEFINED MISAPPROPRIATION THEORY IS CONSISTENT WITH THE PLAIN LANGUAGE, LEGISLATIVE HISTORY AND PURPOSE OF SECTION 10.

A. The "Misappropriation Theory" Is Consistent With This Court's Prior Interpretations Of The Statutory Language Of Section 10(b).

Seventeen years after itself planting the seeds for the "misappropriation theory" in individual opinions in *Chiarella v. United States*, 445 U.S. 222, 100 S. Ct. 1108 (1980), this Court now squarely faces whether the theory is valid in its review of James O'Hagan's conviction. The theory upon which his conviction rests — the "misappropriation theory"— is consistent with both the plain language of Section 10(b) of the Act and this Court's prior interpretations of the statute.

In *Chiarella*, this Court set forth the "classic theory" of insider trading liability, finding that an obligation to disclose material nonpublic information or abstain from trading attaches to corporate insiders based on "(i) the existence of a relationship affording access to inside information to be available only for a corporate purpose, and (ii) the unfairness of allowing a corporate insider to take advantage of that information by trading without disclosure." *Chiarella*, 445 U.S. at 227. However, Justice

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(1996) ([o]ur ruling today should in no manner be understood as condoning O'Hagan's conduct. From the record, it appears as though O'Hagan, then an attorney, engaged in at least some transactions in Pillsbury securities after learning privileged, confidential information that his law firm was representing a client intending a takeover of Pillsbury. Such conduct is certainly unethical and immoral and must be condemned, which we hasten to do."). Under the "personal gain" test, both Bryan and O'Hagan would be guilty of violating Section 10(b) and Rule 10b-5, a result which clearly comports with the purpose of the statute.

Stevens and Justice Brennan in concurring opinions, and Chief Justice Burger in his dissent, each articulated a theory of liability based not on Chiarella's breach of duty to the target company's shareholders, but rather on his breach of fiduciary duty owed to his own employer, from whom he had misappropriated the information, and the acquiring corporation that had hired it. These opinions formed the basis for the development of the misappropriation theory of liability under Section 10(b).

The misappropriation theory expands the reach of Section 10(b) to outsiders and their tippees. Under the misappropriation theory, a person trading on material nonpublic information improperly obtained from an outsider violates Section 10(b). Thus, the misappropriation of material, nonpublic information from its lawful possessor is regarded as a sufficient breach of fiduciary duty 'in connection with' the purchase or sale of a security to justify liability under Section 10(b). *See Maio*, 51 F.3d at 631.

The Second Circuit was the first circuit to adopt the misappropriation theory. In *United States v. Newman*, 664 F.2d 12 (2nd Cir. 1981), the government brought criminal charges for a violation of Section 10(b) against two employees of separate investment banks who misappropriated confidential information regarding pending tender offer targets and then conveyed that information to Newman and two other traders who purchased stock in the target companies. Noting that this Court had left open the question whether the misappropriation of confidential information constitutes fraud for purposes of Rule 10b-5, the *Newman* court held that the appellants' theft of valuable non-public information from their employers was sufficient to constitute fraud for purposes of the rule, and reasoned that by sullying the reputation of the investment banks as safe repositories of client confidences, the appellants fraudulently deprived their employers of value "just as surely as if they had stolen cash or securities." *Newman*, 664 F.2d at

17 (citations omitted). The court found that the fraud was "in connection with" the purchase and sale of the securities because the appellants' "sole purpose" in misappropriating confidential information was to purchase shares of target companies. *Newman*, 664 F.2d at 18.

The Second Circuit's decision in *Newman* adopted the "fraud on the source" version of the misappropriation theory discussed by Justice Stevens in his concurring opinion in *Chiarella*. As refined by further decisions, the theory generally provides that Section 10(b) and Rule 10b-5 thereunder are violated when a person:

(i) misappropriates material non-public information,

(ii) by breaching a duty arising out of a relationship of trust and confidence, and

(iii) uses that information in a securities transaction,

(iv) even though he or she owed no duty to the shareholders of the traded stock. *See SEC v. Clark*, 915 F.2d 439, 443 (9th Cir. 1990).

This fraud on the source theory has been developed in a series of other Second Circuit decisions, (*see, e.g., SEC v. Materia*, 745 F.2d 197 (2nd Cir. 1984), *cert. denied*, 471 U.S. 1053 (1985); *United States v. Carpenter*, 791 F.2d 1024 (2nd Cir. 1986), *aff'd*, 484 U.S. 19 (1987); *United States v. Chestman*, 947 F.2d 551 (2nd Cir. 1991), *cert. denied*, 503 U.S. 1004 (1992)), and has been adopted by the Third (*see, e.g., Rothberg v. Rosenbloom*, 771 F.2d 818, 822 (3rd Cir. 1985)), Seventh (*see, e.g., SEC v. Cherif*, 933 F.2d 403 (7th Cir. 1991), *cert. denied*, 502 U.S. 1071 (1992)), and Ninth (*see, e.g., SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990)) Circuits. Until the Fourth Circuit's decision in *United States v. Bryan*, 58 F.3d 933 (4th Cir. 1995),

which the court below relies on heavily, the validity of the misappropriation theory under Section 10(b) had been uniformly recognized by the lower courts.

This Court should restore that uniformity by upholding the "misappropriation theory" as valid under Section 10(b). The statutory language, of course, must start the analysis as no agency rule or theory of liability can go beyond the Act. *Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, __, 114 S. Ct. 1439, 1444 ("the scope of conduct prohibited by Section 10(b) [is controlled] by the text of the statute"); *Chiarella*, 445 U.S. at 234 ("the 1934 Act cannot be read more broadly than its language and the statutory scheme reasonably permit.") It is now well-established that a violation of Section 10(b) or Rule 10b-5 requires conduct involving manipulation or deception, and that the fraud be "in connection with the purchase or sale of any security." *Santa Fe*, 430 U.S. at 473.

The Eighth Circuit, we respectfully suggest, reads these requirements too narrowly to demand "a particularized showing of misrepresentation or nondisclosure," *O'Hagan*, 92 F.2d at 618, to the other party in a securities transaction. The plain language of Section 10(b) does not limit its reach to fraudulent misrepresentations or omissions directed to the seller or purchaser of a given security. Congress chose the more expansive construction of prohibiting manipulative or deceptive conduct against any person as long as such conduct arose in connection with the sale or purchase of securities.[7]

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7. Both the *Bryan* and *O'Hagan* courts found that the improper conduct sought to be reached under the misappropriation theory was adequately addressed by federal criminal mail and wire fraud statutes and state fraud

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Nor do the Court's most applicable precedents preclude adoption of a clearly articulated misappropriation theory. In *Chiarella*, this Court declined to reach the issue because the jury had not been instructed on the theory. Accordingly, the language in *Chiarella* regarding "parties to a transaction" should not be interpreted as deciding the very issue the Court expressly reserved to a later day. *Chiarella*, 445 U.S. at 236. The misappropriation theory is also consistent with the Courts' holding in *Dirks* that an "insider will be liable under Rule 10b-5 only where he fails to disclose material nonpublic information before trading on it [in violation of a duty to disclose or abstain] and thus makes 'secret profits.' " *Dirks*, 463 U.S. at 654. In fact, in exonerating Dirks, the Court expressly noted that "there was no expectation by Dirks' source that he would keep their information in confidence. **Nor did Dirks misappropriate or illegally obtain the information about Equity Funding.**" *Id.* at 666 (emphasis added).

Likewise, in *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 105 S. Ct. 2622 (1985), a case in which the Court addressed the common law *in pari delicto* defense in Section 10(b) actions, the Court stated in dicta that "we have also noted that a tippee may be liable if he misappropriate[s] or illegally obtains . . . information." *Id.* at 313 n. 22 (citing *Dirks* and the

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law. This argument is problematic in several respects. Indeed, since the SEC has no authority to bring actions under the federal mail and wire fraud statutes, which are general criminal statutes, it is questionable whether it would have the authority to even investigate possible insider trading offenses involving only misappropriated information. Thus, neither the SEC nor any other federal agency would have authority to bring civil insider trading cases under the misappropriation theory. As the SEC is the principal agency responsible for protecting investors and the integrity of the market, it would have insufficient enforcement authority to reach conduct which threatens securities markets in these areas. Lastly, securities markets are global in character and state law cannot be depended on to consistently and adequately regulate prohibited conduct in those markets.

legislative history of the Insider Trading Sanctions Act of 1984). O'Hagan's conviction in particular, and the misappropriation theory in general, do not rest on liability imposed "merely from one's ability to acquire information because of his position in the market," *Dirks*, 463 U.S. at 657, but rather on the misuse of that information in the market for one's own personal gain. O'Hagan's actions go to "the heart of what the securities laws are intended to prohibit." *Chiarella*, 445 U.S. at 246 (Blackmun J., dissenting).

This Court's decision in *Dirks* contemplates that liability for insider trading would at least extend to individuals such as O'Hagan who may be considered "temporary insiders." In considering the scope of insider trading liability, this Court observed that fraud, referring to manipulation or deception, "derives from the inherent unfairness involved where one takes advantage" of "information intended to be available only for a corporate purpose and not for the **personal benefit** of anyone." *Dirks*, 463 U.S. at 654 (emphasis added). In reiterating that under the deceptive prong of Section 10(b), liability for trading on insider information was premised on the use of material information for personal benefit, rather than the benefit of the corporation, the Court noted:

> Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders. The basis for recognizing this fiduciary duty is not simply that such persons acquired nonpublic corporate information, but rather that they have entered into a special confidential relationship in the conduct of the business of the enterprise and are **given access to**

> **information solely for corporate purposes. . . .**

Id. at 677 n. 14 (emphasis added).

O'Hagan would, in fact, be liable under the "classical theory" of insider trading but for the fact that he bought Pillsbury call options and common stock rather than the securities of Grand Met. It would be anomalous if the securities laws' reach to O'Hagan depended on whether he traded in Pillsbury securities and options rather than those of Grand Met. Indeed, purchase of the target's securities, such as Pillsbury, on the basis of insider information could drive up the price of the target's securities and thus be more harmful to Grand Met than trading in its own stock based on insider information.

The lower courts have recognized that "temporary insider" liability is a tacit recognition of the misappropriation theory in a limited context. *See Chestman*, 947 F.2d at 566 (finding that the temporary insider theory of prosecution might well have covered the activities of some persons found guilty under the misappropriation theory). Even the court in *Bryan* conceded that many of the people who would fall within the ambit of the misappropriation theory had a recognized obligation to disclose or abstain from trading, such as underwriters, accountants, lawyers or consultants working for a corporation. *Bryan*, 58 F.3d at 953. AIMR strongly believes that O'Hagan as a temporary insider, as defined by *Dirks*, had a duty to disclose or abstain from trading in the stock of any company to which his insider information related.

B. Subsequent Congressional Actions Support (And May Be Read As Having Ratified) The Misappropriation Theory.

In enacting Section 10(b), Congress sought to prohibit "those manipulative and deceptive practices which have been

demonstrated to fulfill no useful function." S. Rep. No. 792, 73rd Cong. 2d Sess. (1934). *See also Santa Fe*, 430 U.S. at 477, 478 (the fundamental purpose of the 1934 Act is "to substitute a philosophy of full disclosure for the philosophy of caveat emptor.") (citations omitted). Congress has on two separate occasions since this Court's decision in *Chiarella* and *Santa Fe* expressly endorsed the misappropriation theory as reaching the type of manipulative and deceptive practices proscribed by Section 10(b). AIMR believes that Congress's approval of the theory since this Court's *Chiarella* and *Dirks* decisions is an important factor in determining whether the theory satisfies the "deception" and "in connection with" requirements of Section 10(b). *See Bateman Eichler, Hill, Richards, Inc. v. Berner*, 472 U.S. 299, 105 S. Ct. 2622 (1985) (considering the legislative history of the Insider Trading Sanctions Act of 1984 in interpreting the relative culpability of tippers and tippees under Section 10(b)).

In 1984, Congress adopted the provisions of the Insider Trading Sanctions Act of 1984 (the "1984 Act"), which among other things provided the SEC with the ability to seek a new civil penalty of up to three times the amount of profit gained or loss avoided by a person who violates the federal securities laws by trading on the basis of material non-public information. *See* H.R. Rep. No. 355, 98th Cong., 2nd Sess. 1 (1983), *reprinted in* 1983 U.S.C.C.A.N. 2274. The House Report accompanying the legislation clearly established that Congress considered the misappropriation theory a valid part of the judicial framework available to combat illegal trading under Section 10(b). The Report stated:

> Since its creation the [SEC] has . . . appropriately used the antifraud provisions to remedy unlawful trading and tipping by persons in a variety of positions of trust and confidence who have illegally

> acquired or illegally used material nonpublic information."

Id. at 1.

Significantly, in enacting the 1984 Act, Congress refused to supply a definition of "insider trading," in part because it considered insider trading jurisprudence, including the misappropriation theory, "sufficiently well-developed at this time to provide adequate guidance." *Id.* at 13 n.20 (citing *United States v. Newman*, 664 F.2d 12 (2nd Cir. 1981), which applied the misappropriation theory) (footnote omitted).

Indeed, the House Report unequivocally stated that misappropriation of confidential information is exactly the type of "deception" sought to be prohibited by Section 10(b):

> In other areas of the law, deceitful misappropriation of confidential information by a fiduciary, whether described as theft, conversion, or breach of trust, has consistently been held to be unlawful. The Congress has not sanctioned a less rigorous code of conduct under the federal securities laws.

H.R. Rep. No. 355 at 5.

Congress again expressly endorsed the misappropriation theory as addressing the type of conduct proscribed by Section 10(b) when it considered and passed the Insider Trading and Enforcement Act of 1988 (the "1988 Act"). *See* H.R. Rep. No. 910, 100th Cong., 2d Sess. 10 (1988), *reprinted in* 1988 U.S.C.C.A.N. 6043, 6047. In summarizing the parameters of insider trading restrictions as interpreted by the federal courts, Congress took special note of the misappropriation theory as developed by the Second Circuit:

> In cases where a trader did not have a duty to disclose material nonpublic information to the other party to the transaction, the SEC and the Department of Justice have pursued insider traders using an alternative theory: that individuals have a duty not to "misappropriate" information from their employers or otherwise in breach of a fiduciary or other relationship of trust and confidence, and commit securities fraud when they trade in possession of misappropriated information or tip others who trade. Under current case law, the SEC must establish that the person misusing the information has breached either a fiduciary duty to shareholders or some other duty not to misappropriate insider information. Within the court-developed parameters for insider trading, courts that have addressed the issue have also broadened the doctrine of insider trading to include trading and tipping by persons who misappropriate material nonpublic information from sources other than market participants. That was the theory underlying the case of *United States v. Carpenter*.

Id. at 10 (citations omitted). Although the split decision by this Court in the *Carpenter* case left the misappropriation theory "unresolved nationally," the House Committee believed that "this type of security fraud should be encompassed within Section 10(b) and Rule 10b-5." *Id.*

In considering the 1988 Act, Congress not only roundly endorsed the misappropriation theory as proscribing "deceptive" practices within the plain language of Section 10(b), but also

implicitly endorsed the theory as satisfying Section 10(b) and Rule 10b-5's requirements that the proscribed deceptive conduct be "in connection with" the purchase or sale of securities. In discussing the 1988 Act's express private right of action for contemporaneous traders injured by insider trading, the Committee report is explicit in stating that such rights extend to actions brought under the misappropriation theory.

> **In particular, the codification of a right of action for contemporaneous traders is specifically intended to overturn court cases which have precluded recovery for plaintiffs where the defendant's violation is premised upon the misappropriation theory.** *See e.g., Moss v. Morgan Stanley*, 719 F.2d 5 (2nd Cir. 1983). The Committee believes that this result is inconsistent with the remedial purposes of the Exchange Act, and that the misappropriation theory fulfills appropriate regulatory objectives in determining when communicating or trading while in possession of material nonpublic information is unlawful.

H.R. Rep. No. 910 at 26-7 (emphasis added).

By providing a private right of action for contemporaneous traders who pursue a Section 10(b) claim under the misappropriation theory, Congress made clear that the theory satisfies the plain language of Section 10(b) that requires that deceptive practices be "in connection with" the purchase or sale of securities. Unlike the *O'Hagan* and *Bryan* courts below, Congress has expressed its opinion that the deceptive practice need only be "in connection with" the wrongdoer's own purchase or sale of securities. This subsequent legislative history is as relevant to interpretation of Section 10(b) here at it has in

Bateman supra. The 1984 and 1988 Acts may be fairly read as rising to the level of a "ratification" of the "misappropriation theory," as Congress codified that theory in granting the SEC the right to seek new civil penalties for trading on the basis of misappropriated material, nonpublic information and providing a private right of action for contemporaneous traders injured by insider trading. *See Red Lion Broadcasting Co. v. FCC*, 395 U.S. 367, 380-381, 89 S. Ct. 1794, 1801-02 (1969) (subsequent legislation declaring the intent of an earlier statute is entitled to great weight in statutory construction).

In fact, the Ninth Circuit, in *SEC v. Clark*, 915 F.2d 439 (9th Cir. 1990) specifically relied on the legislative history of the 1984 and 1988 Acts in holding that the misappropriation theory is compatible with the broad language of Section 10(b) and Rule 10b-5. Inexplicably, neither the *O'Hagan* decision below nor the Fourth Circuit's *Bryan* decision addressed the unequivocal Congressional support for the misappropriation theory expressed in the 1984 and 1988 Acts. Given Congress's clear acceptance of the misappropriation theory as effectuating the intent of Section 10(b) and Rule 10b-5, this Court should reverse the Eighth Circuit's vacation of O'Hagan's convictions under the securities laws based on the misappropriation theory.

CONCLUSION

Based on the foregoing argument and authority, this Court should reverse the Eighth Circuit's holding and reinstate the convictions against James O'Hagan based on the misappropriation theory, and clarify that theory as set forth above.

Respectfully submitted,

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